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The Effect of Lilly on the Disallowance of Expense and Loss Deductions Deemed Contrary to Public Policy

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COMMENTS

THE EFFECT OF LILLY ON THE DISALLOWANCE OF EXPENSE AND LOSS DEDUCTIONS DEEMED CONTRARY TO PUBLIC POLICY

Neither the Internal Revenue Code of 1939 nor 1954 has expressly prohibited the deduction of any business expense of any amount suffered as a loss on the ground that to allow such deduction would be against public policy. The doctrine under which such deductions have been disallowed has been judicially developed.

Prior to 1951, the public policy test was being used in certain fact situations, but its application was becoming vague, hazy, and somewhat limitless.[1] A United States Supreme Court decision in 1943 had ruled that certain business expenses would be disallowed " . . . in order that tax deduction consequences might not frustrate sharply defined national or state policies prescribing particular types of conduct."[2] But even this criterion was too broad, for in *Lilly v. C. I. R.* the Supreme Court apparently intended to narrow the scope of the doctrine by declaring that "The policies frustrated must be national or state policies *evidenced by some government declaration of them*."[3] [Emphasis supplied]

There remained, however, some questions unanswered. The precise application and scope of the rule was not completely and clearly determined. Evidence of this are subsequent decisions which have ignored *Lilly* or at least considered it not mnadatory in the particular fact situations before the court, the proposing by other courts of a different test for allowing or disallowing deductions involving public policy, and the granting of certiorari by the Supreme Court in three rather recent cases involving public policy considerations.

One probable cause of the confusion still existing is the manner of expression employed by the Supreme Court in proposing the rule in *Lilly*:

> "Assuming for the sake of argument that, under some circumstances, business expenditures which are ordinary and necessary in the generally accepted meanings of those words may not be deductible as 'ordinary and necessary' expenses under Sec. 23 (a) (1) (A) when they 'frustrate sharply defined national or State policies prescribing particular types of conduct,' nevertheless the expenditures now before us do not fall into that class."[4]

The rule is negatively stated and permits the argument to be forwarded, on the basis of the words "*may* not be deductible," that *Lilly*

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[1] See Comment, 51 COL. L. REV. 752 (1951), for a pre- *Lilly* analysis of the public policy test.
[2] C.I.R. v. Heininger, 320 U.S. 467 (1943).
[3] Lilly v. C.I.R., 343 U.S. 90 (1951).
[4] *Id.* at 94.

does not *direct* that business expenses be disallowed because contrary to sharply defined, governmentally declared public policy. Also, from the following dicta:

> "We do not have before us the issue that would be presented by expenditures which themselves violated a federal or state law or were incidental to such violations. In such a case it could be argued that the outlawed expenditures, by virtue of their illegality were not 'ordinary and necessary' business expenses within the meaning of Sec. 23 (a) (1) (A)."[5]

Together with the language in the previous quotation, it appears that the question is left open whether, in the light of a finding that expenses which violated federal or state laws or were incidental to such violations were ordinary and necessary, such expenses, nevertheless must be disallowed if contrary to public policy. Another inherent vagueness in the *Lilly* rule is the term "governmental declaration" of national or state policies. This may be taken to mean statutes, but conceivably the phrase could include judicially declared public policy as well. And, assuming a governmental declaration of public policy is found, when is it sharply defined? And when frustrated?

What influence *Lilly* has had on subsequent litigation in various areas involving public poilcy will be examined in the following discussion.

I. Public Policy As Expressed by Statutes

Governmentally declared public policy is most frequently expressed in statutes, state and federal. Where the statute provides different penalties for wilful and non-wilful violations, courts have accordingly treated deductions of these penalties as business expenses differently, allowing the deduction of penalties incurred due to non-wilful violations[6] and disallowing the deduction of wilful violation penalties.[7] The reason advanced by the courts for according different treatment to non-wilful violations is that, although there is sharply defined public policy expressed, the deduction of penalties incurred due to non-wilful violations does not frustrate public policy. Where the statute itself makes no distinction between wilful and non-wilful violations, the deduction of penalties for all violations, wilful or not, has been held to frustrate public policy and consequently are disallowed, *i.e.*, where profits are returned to a corporation pursuant to Sec. (b) of the Securities Exchange Act reating to insiders' profits.[8]

Fines incurred due to violations of statutes are held to be not de-

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[5] *Id.* at 95.
[6] Phillip E. Ludwig and Frances D. Kiernan, P-H 1954 T.C. Mem. Dec. par. 147 (OPA violations).
[7] George Schaffer and Sons v. C.I.R., 209 F. 2d 440 (2nd Cir. 1953); Union Packing Co., P-H 1955 T.C. Mem. Dec. 308.
[8] Robert Lehman, 25 T.C. No. 75 (1955); William F. Davis, Jr., 17 T.C. 549 (1951); William L. Dempsey, P-H 1951 T.C. Mem. Dec. 281.

ductible where the fines were incurred due to overweight trucks[9] and gambling offenses.[10] The fines incurred in the trucking cases were imposed by a statute found to be penal. Perhaps a finding that the statute imposed the fines as a remedial measure, *i.e.*, to recover for damage done to the roads, and therefore, in effect, a toll paid for the use of the highways, would result in a contrary decision. Where statutes make the expenditures themselvese a violation of law, such expenses have usually been disallowed as deductions. Some examples of the above mentioned situation are: protection payments made to city officials to effect freedom from prosecution for operating slot machines in violation of law;[11] payments made to a director of state hospitals to influence his buying of supplies in favor of the payer;[12] and expenses incurred in purchasing liquor in violation of a state statute.[13] Expenses which themselves are not illegal but incurred in the operation of a business or activity declared unlawful by state law have also been disallowed where the payments involved expenditures for medical supplies of an abortionist and kickbacks by such abortionist to persons who referred patients to him,[14] and expenditures for the purchase of liquor to be given away as gifts to promote its sale where such gifts were forbidden by state law.[15]

In addition to the aforementioned state and federal statutes evidencing a declaration of public policy, a court has found such declaration also in a city ordinance[16] complementing a state gambling statute. Somewhat related to the above decision finding public policy expressed in statutes are those decisions denying the deduction of lobbying expenses as a business expense[17] whether paid to an organization engaged in lobbying[18] or spent by the taxpayer himself in carrying on lobbying activities,[19] unless they are the ordinary and necessary expenses of a professional lobbyist.[20] The denial of lobbying expenses as a deduction is based upon a federal tax reguglation[21] disallowing a charitable con-

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[9] Tank Truck Rentals, Inc., 242 F.2d 14 (1957), *cert. granted,*——U.S.——; Hoover Motor Express Co., Inc.,, 241 F.2d 459 (1957), *cert. granted,*——U.S.——.

[10] Automatic Cigarette Sales Corp. v. C.I.R., 234 F.2d 825 (4th Cir. 1956).

[11] Samuel Guralnick, P-H 1955 T.C. Mem. Dec. par. 26; Charles A. Clark, 19 T.C. 48 (1952).

[12] William T. Stover Co., 27 T.C. No. 48 (1956).

[13] Hiram E. Bowles, P-H 1954 T.C. Mem. par. 160; G. E. Fuller, 20 T.C. 309 (1953).

[14] Estate of Joseph Karger, P-H 1954 T.C. Mem. Dec. par. 204.

[15] Fred D. Newman, P-H 1952 T.C. Mem. Dec. par. 267.

[16] See note 10 *supra.*

[17] American Hardware and Equipment Co. v. C.I.R., 202 F.2d 126 (8th Cir. 1952).

[18] Herbert Davis, 26 T.C. No. 4 (1956); McClintock-Trunkey v. C.I.R., 19 T.C. 297 (1952).

[19] William T. Stover Co., see note 12 *supra;* Revere Racing Assn. v. Scanlon, 137 F. Supp. 293 (D. C. D. Mass. 1955).

[20] Black v. U.S., 129 F. Supp. 956 (Ct. Cl. 1955).

[21] U.S. Treas. Reg. 118, §39.23 (q)—1 (1954).

tribution deduction of such expenses. The courts have found this regulation to be expressive of congressional *intent* to disallow any deduction, as a business expense or otherwise, of lobbying expenses.

II. Judicially Declared Public Policy

Governmentally declared public policy apparently includes judicially declared public policy as well as legislatively declared policy. Payments made to an extortioner have been disallowed as a business expense deduction because to do so would be contrary to public policy.[22] In a closely analogous situation, however, a taxpayer was allowed a loss deduction for money lost through a Spanish Prisoner swindle.[23]

The extortion payment situations can be said to have been decided on judicially declared public policy since the taxpayers themselves violated no statute by making the payments. There was no statute prescribing their conduct. If govermenally declared public policy included judicially declared policy, then, perhaps, this criterion for disallowing deductions could become boundless in its application, a result which *Lilly* apparently attempted to prevent.

III. Lilly Has Been Ignored In Some Cases Involving Public Policy

Lilly has been ignored in some cases involving public policy considerations. The OPA violation decisions are based on *Jerry Rossman v. C.I.R.*[24] decided before *Lilly* which in turn is founded upon *C.I.R. v. Heininger*[25] which is cited with approval in *Lilly*. Since the OPA cases are decided upon the theory that the deduction of penalties incurred due to non-wilful violations does not frustrate public policy. and since *Lilly* approved the rule in *Heininger* in regard to frustration and added only that public policy must be evidenced by some governmental declaration of it, the OPA decisions are consistent with *Lilly*. The Seventh Circuit has ignored *Lilly* but for another reason. In dealing with expenses involving public policy considerations, that court has proposed a test somewhat different from that propounded in *Lilly*.

IV. A New Test Is Proposed

The Seventh Circuit's test was proposed in deciding that expenses which themselves were illegal, and other expenses of a business which was illegal were deductible as ordinary and necessary business expenses.[26] According to the *Doyle* decision, the test is whether the expenses, economically, are an integral part of the business. If they are, then they are deductible whether they be lawful or unlawful. The reasoning supporting this test is expressed as follows:

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[22] Samuel Towers, 25 T.C. 199 (1955); Terminal Equipment Corp., P-H 1955 T.C. Mem. Dec. par. 132.

[23] Curtis H. Muncie, 18 T.C. 849 (1952).

[24] 175 F.2d 711 (2nd Cir. 1949).

[25] See note 2 *supra*.

[26] C.I.R. v. Doyle, 231 F.2d 635 (1956); James Ross v. C.I.R., 241 F.2d 47 (7th Cir. 1957), *cert. granted*,——U.S.——.

> "To the extent that such ordinary and necessary business expenses exist, a holding that they are undeductible by a handbook operator in a state in which the business is unlawful, would mean that such a tax would be levied by the Federal Government on gross income while a holding that they are deductible in a state in which the business is lawful, would mean that such a tax would be levied on only net income. We cannot believe that the Congress intended this inequitable result."[27]

Dicta in the opinion cited examples of expenses which were considered not an integral part of the business, such as bribes paid to public officers, fines and penalties for violations of state and federal statutes and certain types of lobbying expenses.

If *Lilly* bars deductions otherwise ordinary and necessary when their allowance would frustrate public policy, *Lilly* would aid the enforcement of state and federal statutes by preventing the gaining of any tax advantage by reason of the deduction of expenses of an illegal business, whereas *Doyle* would put all taxpayers on even footing as far as their federal income tax is concerned regardless of the business or type of expense as long as the expenses meet the integrality test.

From a close reading of the language in the *Lilly* opinion, we find that the rule had been negatively stated, and if we wished to be critical, we might conclude that the rule is dicta, and actually only permitting, not directing, disallowance of deductions when to allow them would frustrate public policy. But the Court of Appeals in deciding *Doyle* apparently did not consider *Lilly* to be only permissive because to do so would create the same kind of inequality that the court attempted to avoid, *i.e.* depending on a particular court's application of the public policy test, an illegal bookie could or couldn't take deductions for his expenses, the same problem that the court saw in the tax treatment of bookies which operated legally in one state and illegally in another.

If the language in the *Lilly* decision, that ordinary and necessary business expenses *may* not be deductible as ordinary and necessary expenses when they frustrate sharply defined public policy, and the further language that *it could be* argued that expenses illegal in themselves or incidental to violations of state or federal laws are not ordinary and necessary by virtue of their illegality, permits the conclusion that the question is left open whether expenses illegal in themselves or incidental to illegal activity which are found to be ordinary and necessary expenses must be disallowed because against public policy, then the integrality test proposed by the Seventh Circuit may not be inconsistent witht the rule in *Lilly*. The overweight truck fine cases and the abortionist case might also be decided differently and remain consistent with *Lilly* if the expenses were found to be ordinary and ne-

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[27] 231 F.2d at 638.

cessary. The granting of certiorari by the United States Supreme Court in the bookmaking and truck fines cases may result in a decision clearly stating whether such question is left open.

V. Conclusion

The adoption of the Seventh Circuit's integrality test by the Supreme Court would presumably change the law in some of the areas heretofore discussed. The expenses incurred by an abortionist in purchasing medical supplies considered by the court as the tools of his business, and kickbacks paid by him found to have been paid in direct consequence of his activity could certainly be found to be expenses which are an integral part of the business. Although the *Doyle* and *Ross* decisions expressly exclude fines and penalties from the integrality test, the distinction between expenses which are illegal in themselves, *i.e.,* the payment of wage by a book maker to his employees, and fines which may be incurred because of the same expenses, in view of their practically inseparable connection and integrality in the economic structure of the business, appears somewhat arbitrary. If the fines are incurred in direct consequence of an illegal activity for which deductible expenses are made, then the fines should also be allowed as deductions. If fines are included, then, in the integrality test, the gambling and truck fine cases would also be decided differently. Fines must necessarily be incurred by a gambling organization operating illegally, and therefore this expense may be found to be an integral part of the business. The fines involved in the trucking cases were necessarily incurred in order that taxpayer remain in business. Tank truck rentals, for example, due to wartime restrictions, could procure only certain types of trucks, which because of Pennsylvania statutes must now operate illegally or uneconomically to the extent that competition with other carriers would be impossble.

It is quite probable that the integrality rule of the bookmaking cases will not be adopted by the Supreme Court for the reason that, from the language of the *Doyle* and *Ross* opinions, the public policy criterion, as far as governmentally declared public policy on a State level is concerned, is non-existent. This, at least, is a departure from the basic reasoning of the *Lilly* decision.

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